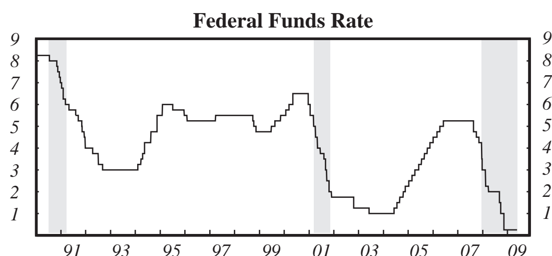
WENTWORTH, HAUSER AND VIOLICH

REVIEW AND OUTLOOK - SUMMER 2009

Decline in global economic activity abating.

While economic conditions remain weak throughout the global economy, there are emerging signs that the contraction in business activity that has encompassed the world over the past year is abating. In response to the worst financial crisis in the post World War II period, virtually every central bank has lowered interest rates to near record levels and undertaken expansionary monetary policies to increase the quantity of money. The Federal Reserve (Fed) has lowered the federal funds rate to between 0.00 and 0.25 percent while the European Central Bank (ECB) which oversees the sixteen-nation euro zone has targeted its rate at 1 percent. The Bank of England has set its overnight lending rate at 0.5 percent, the lowest rate in the 315 year history of the bank. The Bank of Japan has held its rate at 0.10 percent. Additionally, central banks around the world have initiated asset purchase programs to expand their balance sheets in an effort to stabilize the credit markets as well as to increase their money supplies. The Fed, over the course of the past nine months, has increased its balance sheet by a factor of three times by buying mortgage-backed securities, commercial paper, and U.S. Treasury obligations and has set up facilities to aid financial sector companies. The Fed buys these securities from dealer commercial banks. It pays for them by crediting the bank's reserve accounts at the Fed which in turn enables the banks to extend loans. This is the proverbial printing of money.

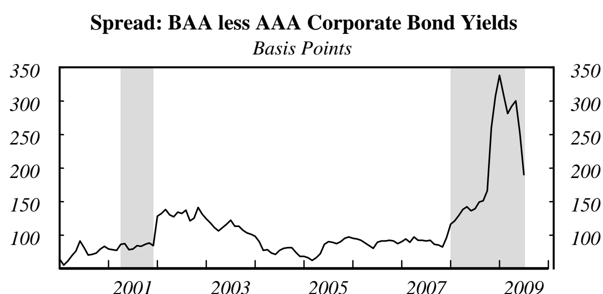


Central banks responding to recession by lowering rates and expanding money supply.

Governments are passing massive spending programs.

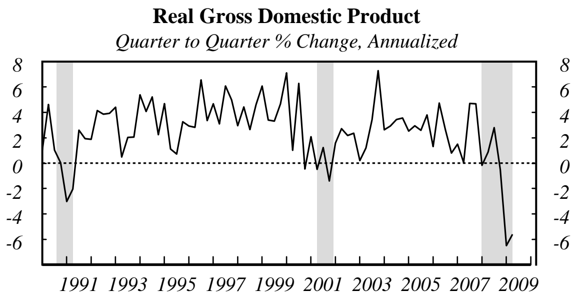
Governments have also responded to the crisis by enacting fiscal stimulus (spending) programs. The United States passed a $787 billion stimulus bill in February, representing about 5.5 percent of Gross Domestic Product (GDP). However, this has had little impact as the total amount spent to date is estimated to be only about 9 percent and the unemployment rate has jumped from 8.1 percent in February to 9.5 percent in June. China has enacted a two-year $585 billion stimulus bill, representing 20 percent of GDP over two years, which is focused on infrastructure building that appears to have had, and will have, a more meaningful impact. Japan, the world's second largest economy, has passed a spending plan that approaches 3 percent of its GDP. Simultaneous spending programs across the globe, taken together, along with aggressive monetary policies may be contributors to the moderation of decline in the global economy. Also at work are the natural forces of the marketplace that correct excesses and imbalances in the economy. Bankruptcies are reducing debt and leverage, price changes are readjusting supply and demand and fear is causing consumers to become thriftier. Year-over-year consumer credit has declined for the first time since 1991. Consumer saving as a percent of income has jumped to near 7 percent from being negative in 2008. Tepid consumer spending has caused manufacturers and distributors to liquidate inventories. Any stabilization in business and consumer spending will bring about inventory reinvestment.

Credit market conditions easing as yield spreads narrow.



Other factors that suggest that the worst of the economic crisis is over include the narrowing of yield spreads between risky and riskless bonds. The spread between high yield (junk) bonds and U.S. Treasuries has fallen in half since the late December peak. The spread between the LIBOR rate and U.S. Treasury bills has returned to pre-crisis levels. Initial unemployment insurance

claims have fallen from their peak. There is also evidence that the pace of job losses is slowing. The ISM surveys of the manufacturing and non-manufacturing sectors of the economy, while still in recessionary ranges, have improved. Durable goods and factory orders have risen in three of the past four months. Commodity prices have improved as have the various stock markets around the world. U.S.-based corporate pre-tax profits rose in the first quarter for the first time in a year and a half, although they trailed the year-earlier period by 18 percent and are down about 25 percent from the peak of the third quarter of 2006. GDP, the total output of goods and services within the United States, fell 5.5 percent in the first quarter of 2009 compared to a decline of 6.3 percent in the fourth quarter of 2008. The estimates for GDP for the second quarter of 2009 ending in June are for a decline of 1-3 percent.



Various measures of economic activity in U.S. appear to have bottomed.

Global economy should exhibit positive growth.

Forecasts for the global and U.S. economies are for improving conditions in the second half of 2009 and a return to growth in 2010. The Organization for Economic Cooperation and Development (OECD) forecast that the global economy will contract 4.1 percent in 2009 and expand 0.7 percent in 2010. The OECD forecast is for the U.S. economy to decline 2.8 percent in 2009 and grow 0.9 percent in 2010. China's economy is forecast to expand 7.7 percent in 2009 and 9.3 percent in 2010.

Policy errors of Depression have been avoided so far.

Some have compared the current recession to the Great Depression of the 1930s. The comparisons are not justified. In the 1930s unemployment rose to 25 percent and for the entire decade never fell below 12 percent. The unemployment rate for June 2009 was 9.5 percent. National output fell by over 30 percent in the 1930s compared to about 3 percent currently. World trade collapsed by over 70 percent in the Great Depression and is down about 9 percent currently. Since the credit crisis emerged in the spring of 2007, less than 100 banks have failed compared to over 9,000 between 1930 and 1933. There were grave policy errors at the start of the Great Depression that have not yet been repeated. In that period the Fed raised interest rates and cut the money supply, the Federal Government passed a draconian tariff bill that set off a worldwide trade war, taxes were raised on individuals and business, and federal spending was reduced in the early years of the Depression.

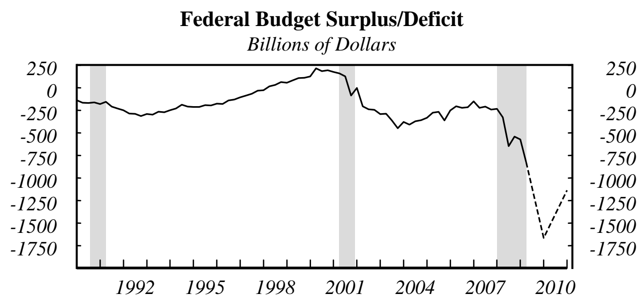
Intrusion of government into private sector unprecedented.

There is one area that is reminiscent of the 1930s and that is the intrusion of the Federal Government into the private sector. Similar to today, the Congress and the Presidency in the 1930s blamed Wall Street, business and "greedy individuals" for the collapse in the economy. Class warfare was used to single out "economic royalists" in an effort to gain popular support for the New Deal. The political agenda was to pursue greater government control over the economy. In so doing, the Roosevelt Administration set up the National Recovery Administration (NRA) to control wages, prices and working hours, the Agricultural Adjustment Administration (AAA) to control agricultural output and prices, the Public Works Administration and Works Progress Administration to dole out billions of dollars of stimulus in a failed effort to promote industrial recovery and unemployment relief. The Civil Works Administration was established to employ people in make-work tasks such as leaf raking. The Administration created the Tennessee Valley Authority whereby the federal government entered and controlled the electric-power industry. A myriad of regulatory programs were instituted, some called for and others not. The federal government became the largest enterprise in America and bureaucracy blossomed. These and other New Deal programs doubled the national debt in the course of six years. Many New Deal reforms were needed and are an underpinning of today's economy including securities laws, deposit insurance, unemployment insurance, Social Security, minimum-wage regulations and labor law. However,

the constitutionality of many New Deal policies was questioned and, indeed, the Supreme Court overturned seven New Deal programs. In overturning the NRA, the Court unanimously held that Congress could not delegate legislative powers to the Executive branch. In defeating the AAA the Court held that its regulatory taxation provisions were unconstitutional.

Government will have greater control over economy.

Economists debate the success of the New Deal in lifting the country out of the Depression. They do not debate that the proponents of the New Deal believed in greater government control of the economy, the development of the welfare state, the redistribution of income, central planning and a limit to market capitalism. At the end of the decade of the 1930s, unemployment was above 17 percent. Despite all the spending, there remained a large gap between output and capacity. The economy had barely returned to the national income level of 1929, even though the country had stepped up military spending to support the allied war effort in Europe. Was it possible that the massive intrusion of the federal government into the private sector actually hindered the economy from recovering? As Amity Shlaes points out in her book *The Forgotten Man*, the per capita national income of the U.S. in 1930 was one-third larger than that of Great Britain and at the end of the decade it was about the same. *The Economist* magazine would later conclude that the U.S recovery was stifled by "institutional obstructions to a free flow of capital".

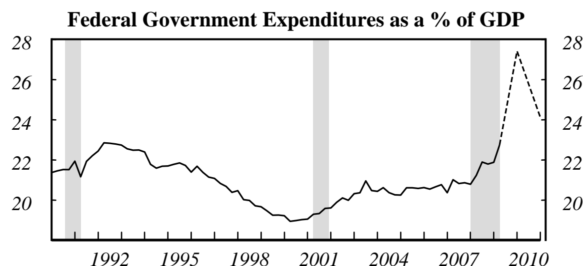


Today the collapse of financial institutions is being used to discredit the whole system of free market capitalism. Politicians are using this sub-sector failure to advance their own political agenda to enlarge the role of government in control of the economy. As President Obama's chief of staff Rahm Emanuel said "You never want a serious crisis to go to waste". The serious crisis was the near collapse of the financial sector, brought about in part by prior government intrusions into the housing market in pursuit of affordable housing. While there is plenty of culpability to assign to the credit crisis, the housing market would not have gone through its boom-bust cycle were it not for the policy pursuits of Freddie Mac and Fannie Mae, the Federal Reserve, the Community Reinvestment Act of 1977, and the encouragement and approval by government regulators of lower lending standards, no down payment loans, and creative mortgage loan terms. These same regulators had to approve Fannie and Freddie's buying and securitizing sub-prime mortgages, again in support of affordable housing. Tax laws encouraged debt and leverage by making interest deductible and double taxing the returns on equity.

The U.S. government now has stakes in the banking, insurance, mortgage, health care, railroad and automobile industries and controls the energy industry. It proposes to control all of the health care industry and to enact cap and trade legislation involving carbon emissions that will fundamentally change the global competitiveness of American producers. Cap and trade is the equivalent of a massive tax increase that would require anyone who drives a car, motorcycle or tractor, uses public transportation or flies in an airplane, uses electricity, or buys a product that emits carbon in its manufacture to pay higher prices. In an effort to reform corporate compensation, the Administration has appointed a "special master for compensation" to review, reject and set pay levels for all TARP recipients and to review compensation policies for all private companies. The Administration encroached on private property rights and the rule of law when it placed secured creditors behind unsecured creditors in orchestrating the bailouts of Chrysler and General Motors. Has Congress delegated legislative powers to the Executive branch (Treasury Department) as was once ruled unconstitutional? Free market capitalism is being eroded. Yet it was free market capitalism that lifted thirty percent of the global economy out of poverty in the past three decades, perhaps the greatest geo-economic change in history.

Free market capitalism being eroded.

Large federal government deficits may ignite future inflationary pressures.



The response of the federal government, the Congress and the Federal Reserve to the financial crisis has been an unprecedented explosion of federal spending. The federal budget deficit for fiscal 2009 will probably exceed $2 trillion or 14 percent of GDP, more than twice the level of the highest prior deficit since World War II. Federal government spending will jump to 28 percent of GDP compared to a historic average of about 20 percent. The federal budget deficit will double within ten years. Long-term U.S. Treasury interest rates have almost doubled in the past six months, in part due to the large expected issuance of federal debt in the months and years ahead. If the Fed is compelled to buy (monetize) some portion of this debt to add to its already swollen balance sheet, inflationary pressures will develop once the global and U.S. economies resume growth.

SUMMARY

Robust recovery in 2010 unlikely given excesses and imbalances still need correction.

The downturn in the United States and global economies is moderating, suggesting that the recessionary environment of the past year and a half will run its course by the end of the year and a return to growth will occur in 2010. However, a robust recovery in economic activity is not forecast given continued high consumer debt levels, weakness in commercial real estate, low housing prices, the gap between capacity and output and continued high unemployment. Fiscal and monetary policies are conducive to inflationary pressures down the road. A return to infrastructure investment in the developing economies of the world in 2010 will increase inflationary prospects and will fuel higher prices for commodities and energy. Interest rates under this scenario will rise. The stock markets became oversold this past March, but the increase in the markets of the past three months suggests a pause is due in the period ahead. A rebound in corporate profits led by improved productivity bodes well for the longer-term outlook for the equity markets.

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